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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

August 2, 1993

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 93-179 - Price Cap Regulation of Local Exchange Carriers; Rate of Return Sharing And Lower Formula Adjustment*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their "*Comments*" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Jo Ann Goddard

Enclosures

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AUG - 2 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Price Cap Regulation of Local Exchange Carriers Rate of Return Sharing And Lower Formula Adjustment	)	CC Docket No. 93-179

COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell (the Pacific Companies) file these comments in response to the Commission's Notice of Proposed Rulemaking (NPRM).[1] The Commission has proposed that the rate of return used to calculate backstop adjustments (sharing or lower end adjustments) be adjusted to include the effect of prior year backstop adjustments. The Commission refers to this adjustment as "add-back". We do not support mandatory add-back for the following reasons.

The Commission observes that add-back of rate of return-based refunds was required under rate of return regulation.[2] This is not dispositive, because of the

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1 Price Cap Regulation of Local Exchange Carriers, Rate of Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179, Notice of Proposed Rulemaking, FCC 93-325, released July 6, 1993 ("NPRM").

2 NPRM, para. 3.

different incentives that price cap regulation is supposed to produce. Unlike rate of return regulation, the Commission intended price cap regulation to "harness the profit-making incentives common to all businesses to produce a set of outcomes that advance the public interest goals of just, reasonable, and nondiscriminatory rates."[3] Carriers are encouraged to reduce their costs or "inputs" by annual productivity adjustments and sharing of earnings that result from any productivity gains that exceed the adjustments.[4] In contrast, "[u]nder rate of return regulation, LECs refund overearnings above the prescribed maximum allowable rate of return, whether through direct payments to customers, rate reductions in a subsequent tariff filing period, or damages awarded after complaints."[5] The same "overearnings" are legally sanctioned under price cap regulation and treated as an incentive for the carrier to increase its efficiencies. In fact, the Commission's holding that it was authorized to require sharing was based in part on the difference between refunds and price cap adjustments.[6]

Requiring add-back would dampen price cap LECs' incentives to become more efficient and is therefore at odds with

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[3] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990) ("LEC Price Cap Order").

[4] Id. at 6787, 6790.

[5] NPRM, para. 5.

[6] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Supplemental Notice of Proposed Rulemaking, released March 12, 1990, para. 172.

the rationale for price cap regulation. As the Commission recognized, add-back works both ways: "Without add-back, ... LECs would share less of their earnings as they approach or exceed the high end of the range, and would receive smaller adjustments when they fell below the low end of the range."[7] Provided they calculate their earnings consistently from year to year, price cap LECs who elect not to add back sharing or lower-end adjustment amounts are simply deciding to take on greater risk than those LECs who elect to add back, much like the decision to adopt a higher productivity benchmark.[8] It would be consistent with price cap regulation for a carrier to assume this risk, because it would increase the incentive to become more efficient.

We believe the best way to address this issue is when the Commission reviews LEC price cap regulation. Add-back is not a requirement of the price cap rules as they now stand. Mandatory add-back is not a "clarification" of the price cap rules. The effect of add-back would be similar to the effect of the permanent automatic stabilizer that the Commission originally proposed but declined to adopt because "based upon a single

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[7] NPRM, para. 13.

[8] Under price cap rules, carriers are given the opportunity to retain more earnings if they adopt a higher productivity benchmark (reduce rates by an additional one percent). Electing not to add back would give the same "greater risk, greater reward" incentive: the carrier could potentially retain more earnings but would surrender some ability to increase rates if it underearned, or vice versa.

year's earnings, [it] created perverse incentives."[9] The Commission said that sharing (unlike the automatic stabilizer) would operate "only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings."[10] Add-back makes sharing into a continuing adjustment. If it required add-back the Commission would be substantively changing the balance of risks and benefits that was struck when the price cap rules were adopted. The price cap rules should not be modified one by one to make them more like rate of return regulation. If the Commission wishes to modify price cap regulation, it should do so with the whole picture in view, not just small parts of it.

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[9] LEC Price Cap Order, 5 FCC Rcd at 6803.

[10] Id.

For the foregoing reasons, we respectfully suggest the proposed rule should not be adopted.

Respectfully submitted,

PACIFIC BELL
NEVADA BELL

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